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In the Supreme Court of the United States

OCTOBER TERM, 1946

No. 1271

THE P. DOUGHERTY COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The prevailing (R. 3–18) and dissenting (R. 18–20) opinions in the Tax Court are reported in 5 T. C. 791. The opinion of the Circuit Court of Appeals (R. 24–31) is reported in 159 F. 2d 269.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on December 23, 1946. (R. 31.) The time for filing a petition for a writ of certiorari was extended to April 21, 1947, by order of this Court dated March 10, 1947. (R. 43.) The petition for certiorari was filed on April 21, 1947.

The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

1. Whether the taxpayer-corporation is entitled under Sections 23, 113 and 114 of the Internal Revenue Code to a greater deduction for depreciation than was allowed by the Commissioner and the courts below.

2. Whether the amount spent by the taxpayer in rebuilding the stern of a barge was deductible under Section 23 of the Internal Revenue Code as a business expense, as the taxpayer contended, or whether it was a capital expenditure under Section 24 of the Internal Revenue Code, as the Commissioner and the courts below determined.

3. Whether the 25% penalty for failure to file an excess profits tax return was properly imposed under Section 291 of the Internal Revenue Code.

STATUTE AND REGULATIONS INVOLVED

These appear in the Appendix, *infra*.

STATEMENT

The Tax Court found the following facts (R. 5–9):

The petitioner (referred to herein as "taxpayer") is a Maryland corporation engaged in the towing and barge transportation business, with its principal offices at Baltimore. It filed

its corporation income and declared value excess profits tax return for the fiscal year ended February 28, 1943, with the Collector of Internal Revenue for the District of Maryland at Baltimore. Taxpayer keeps its books and files its income tax returns on the basis of a fiscal year ending February 28. (R. 5.)

Taxpayer acquired seven wooden barges during the period 1915 to 1918, seven more in 1921, and two steel tugs in 1923. The dates of acquisition and cost of such tugs and barges were as follows (R. 6):

	Date acquired	Cost
Barge *Wilmington*	1915	$51,450.24
Barge *Montank*	1915	51,300.29
Barge *Delaware*	1916	52,141.49
Barge *Baltimore*	1916	49,413.43
Barge *Maryland*	1917	51,966.72
Barge *Providence*	1917	73,280.29
Barge *Annapolis*	1918	72,518.30
Barge *Harford*	1921	90,000.00
Barge *Mayo*	1921	90,000.00
Barge *Allegany*	1921	90,000.00
Barge *Caroline*	1921	90,000.00
Barge *Frederick*	1921	90,000.00
Barge *Garrett*	1921	90,000.00
Barge *Montgomery*	1921	90,000.00
Tug *Ivanhoe*	1923	54,774.75
Tug *Dunmore*	1923	54,774.75
Total		1,141,620.28

The tugs and barges listed above are the only ones to which the depreciation questions raised in this proceeding relate. (R. 6.)

During the years 1940 and 1941 taxpayer expended the following amounts for altering and reconditioning the tugs and barges, which the

parties have stipulated should be capitalized and depreciated at the rate of 10% per annum (R. 7):

Barge *Wilmington*, Oct. 1, 1940	$11,650.00
Barge *Montauk*, Oct. 1, 1940	11,922.86
Barge *Providence*, Nov. 1, 1940	11,871.18
Barge *Baltimore*, Dec. 1, 1940	11,878.93
Tug *Dunmore*, June 10, 1941	34,064.23
Tug *Ivanhoe*, October 31, 1941	42,143.99
Barge *Maryland*, Nov. 1, 1941	15,523.30
Barge *Annapolis*, Nov. 1, 1941	15,262.84
Barge *Delaware*, Dec. 31, 1941	15,465.90

During 1942 taxpayer expended $17,593.32 to replace the stern of the barge *Maryland*. It was found that much of the woodwork had rotted and had to be torn out and replaced. Taxpayer treated this expenditure as ordinary repairs and deducted the cost thereof in its return for 1942. The Commissioner determined that it was a capital expenditure and therefore not deductible in its entirety in that year. (R. 7.)

For all the years prior to 1922, taxpayer computed depreciation on its tugs and barges, both in its books and its income tax returns, on a declining basis at the rate of 10% of the balance at the beginning of each year. A revenue agent who in 1921 made an examination of taxpayer's books for the years 1917 to 1920, inclusive, recommended that this method be changed and that depreciation deductions be taken on a straight-line basis at the rate of 5%. Taxpayer adopted that method in 1922 and has since followed it, both in its books and its returns. For many years taxpayer reported net losses in excess of the depreciation deductions contained in its returns. All of the

depreciation so claimed by the taxpayer in its returns, up to 1942, was allowed by the Commissioner. (R. 7.)

In 1942 taxpayer restored to capital, as excessive depreciation, a portion of the depreciation previously charged off in its books and its returns. Some of its tugs and barges were not in actual use during part or all of the years 1922 to 1942, inclusive. Both of its tugs were idle from early in 1931 until the close of 1941. Three barges were idle continuously from 1931 to 1941, inclusive. Several other barges were idle for all or portions of the years 1930 to 1941, inclusive. During the protracted periods of idleness the tugs were tied up at the Colona shipyard, Norfolk, Virginia, and the barges in the James River near Willcox Farm, all under the care of watchmen. They were all kept painted and in seaworthy condition. According to taxpayer's books of account, the depreciation on the tugs and barges for the time that they were not in use, computed at the rate of 5%, amounted to $530,176.72. Apparently the amount which taxpayer restored to capital represented the depreciation computed on the tugs and barges during the periods of idleness. Its depreciation deductions for 1942 and 1943 were computed on a cost basis, including such restored capital. (R. 7–8.) The 1941, 1942 and 1943 returns showed net losses, depreciation claimed, and depreciation allowed as follows (R. 8):

	1941	1942	1943
Net losses	$35,000.84	$00,779.22	$95,404.88
Depreciation claimed	36,977.50	49,198.62	52,786.72
Depreciation allowed	38,652.39	36,746.60	24,214.74

In computing taxpayer's depreciation for the years 1941, 1942, and 1943, the Commissioner included in the cost basis the remaining original cost of the tugs and barges on hand, with the addition thereto of the cost of reconditioning, which he treated as capital expenditures. He thus allowed a greater depreciation in 1941, before restoration to capital of the prior years' alleged excessive depreciation, than was claimed by taxpayer. (R. 8.)

At the end of taxpayer's taxable year 1941, the original cost of the seven barges acquired during the period 1915 to 1918, inclusive, had been fully written off in taxpayer's books and in its returns, through depreciation deductions. There remained only $3,000 of the original cost of each of the seven barges acquired in 1921 and $5,477.25 of the original cost of each of the tugs. (R. 8–9.)

The taxpayer filed its income and declared value excess profits tax return (Form 1120) for the tax year ended February 28, 1943, but did not file an excess profits tax return on Form 1121. In reporting a loss of $95,404.88 for that year taxpayer deducted, in addition to depreciation in the amount of $52,786.72, a claimed loss on the salvage sale of the barges *Allegany, Caroline,* and *Montgomery* in the amount of $141,000,

and net operating losses for 1941 and 1942 in the total amount of $80,298.06. (R. 9.)

The Tax Court sustained the Commissioner as to all points here involved (R. 9–18), and the Circuit Court of Appeals affirmed (R. 31).

ARGUMENT

1. Section 114 (a) of the Internal Revenue Code provides that the basis for depreciation shall be the adjusted basis provided in Section 113 (b) for the purpose of determining the gain upon the sale or other disposition of the property. Section 113 (b) (1) (B) provides that in determining such basis, proper adjustment shall be made in respect of any period since February 28, 1913, for depreciation to the extent allowed (but not less than the amount allowable) under the Code or prior income tax laws.

Both of the courts below held, correctly, we submit, that the taxpayer could not restore to capital in the year 1942 amounts previously charged off and allowed as depreciation deductions, and thus increase its adjusted basis for depreciation under Section 113 of the Internal Revenue Code. In so holding, they took the view that the taxpayer's tugs and barges which lay idle for varying periods during the years 1922 to 1942, inclusive, were nevertheless subject to depreciation because they were kept in usable condition and were ready for use should the occasion arise. In such circumstances there is no

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adequate basis for taxpayer's contention that the properties were not used in trade or business within the meaning of the tax laws (Section 23 (l) (1) of the Internal Revenue Code, Appendix, *infra;* Section 23 (l), Revenue Acts of 1938, 1936, 1934; Section 23 (k), Revenue Acts of 1932, 1928), which provide for the allowance of depreciation deductions with respect to property used in trade or business. The reason is stated as follows in *Kittredge* v. *Commissioner,* 88 F. 2d 632 (C. C. A. 2d) at page 634:

> To read the phrase "used in the trade or business" as meaning only active employment of property devoted to the business would lead to results which we cannot believe Congress intended. For example, one factory of a large industrial plant may lie idle for a year, and in fact suffer depreciation as great, or greater, than that sustained by the factories in operation. To allow no depreciation for the idle factory would be most unfair to the taxpayer, for he must claim the deduction in his tax return for the year when the depreciation occurs, and may not take it in a later year. See *Hardwick Realty Co.* v. *Commissioner,* 29 F. 2d 498, 500 (C. C. A. 2). Hence we think the phrase should be read as equivalent to "devoted to the trade or business"; that is to say, that property once used in the business remains in such use until it is shown to have been withdrawn from business purposes. * * *

And in *Yellow Cab Co. of Pittsburgh* v. *Driscoll*, 24 F. Supp. 993 (W. D. Pa.), the same result was reached. Cf. *United States* v. *Ludey*, 274 U. S. 295; *Beckridge Corp.* v. *Commissioner*, 129 F. 2d 318 (C. C. A. 2d); *United States Industrial Alcohol Co.* v. *Helvering*, 137 F. 2d 511, 517 (C. C. A. 2d); *Herder* v. *Helvering*, 106 F. 2d 153, 162 (App. D. C.), certiorari denied, 308 U. S. 617.

Moreover, under this Court's decision in *Virginian Hotel Corp.* v. *Helvering*, 319 U. S. 523, affirming 132 F. 2d 909 (C. C. A. 4th), it is immaterial that for many early years the taxpayer in the instant case reported net losses in excess of the depreciation deductions which it claimed in its returns. Both of the courts below so held (R. 10–11, 28.)

In support of its application for certiorari the taxpayer relies upon cases (*Becker* v. *Anheuser-Busch, Inc.*, 120 F. 2d 403 (C. C. A. 8th), certiorari denied, 314 U. S. 625; *Gambrinus Brewing Co.* v. *Anderson*, 282 U. S. 638; *United States* v. *Real Estate-Land Title & Trust Co.*, 102 F. 2d 582 (C. C. A. 3d), affirmed, 309 U. S. 13; and *Helvering* v. *Owens*, 305 U. S. 468), which are not at variance with the instant decision. Three of those cases involved claims for "obsolescence" and turned upon the meaning of that term, and the other case (*Helvering* v. *Owens*) involved the basis for computing loss from damage by casualty to property acquired and used for pleasure.

For the same reasons, there is no merit in the taxpayer's further contention (Pet. 8, 12–13) that in the computation of invested capital the alleged excessive depreciation taken in prior years should be restored to capital and the accumulated earnings and profits at the beginning of the taxable year, includible in equity invested capital under Section 718 (a) (4) (Appendix, *infra*), correspondingly increased. Both of the courts below correctly so held. (R. 16, 26–27.)

2. The courts below properly held that the cost of replacing the stern of the barge *Maryland* should be capitalized. This item was not an incidental repair which should be treated as a deductible business expense. It was a major replacement the cost of which should be recovered through depreciation. The regulations are in harmony with this view (Treasury Regulations 111, Section 29.23 (a)–4; Treasury Regulations 103, Section 19.23 (a)–4, Appendix, *infra*) and so are the other available authorities: *Hubinger* v. *Commissioner,* 36 F. 2d 724 (C. C. A. 2d), certiorari denied *sub nom. New Haven Bank* v. *Commissioner,* 281 U. S. 741; *Black Hardware Co.* v. *Commissioner,* 39 F. 2d 460 (C. C. A. 5th), cercertiorari denied, 282 U. S. 841; *Buffalo Union Furnace Co.* v. *Helvering,* 72 F. 2d 399 (C. C. A. 2d).

Moreover, as pointed out by the Circuit Court of Appeals (R. 29), it is peculiarly within

the competence of the Tax Court to determine where to draw the line in cases of this kind, and the decision of the Tax Court should not be disturbed unless manifestly wrong. *Dobson* v. *Commissioner*, 320 U. S. 489; *John Kelley Co.* v. *Commissioner*, 326 U. S. 521.

The taxpayer asserts (Pet. 11) that *Zimmern* v. *Commissioner*, 28 F. 2d 769 (C. C. A. 5th), is in conflict with the decision here. In the *Zimmern* case the court allowed the deduction of the cost of repairs necessary to restore a sunken barge to the condition it was in before it sank; but that case did not involve a major replacement such as the one here, and in any event the decision is difficult to reconcile with the later decision of the same court in the *Black Hardware* case, *supra*, where the cost of raising the floor of a building was held not deductible.

In the circumstances we submit that the decision as to this point is in accordance with the law and the regulations; there is no direct conflict, and no occasion for further review by this Court.

3. The other point as to which certiorari is sought is whether the 25% penalty for failure to file an excess profits tax return was properly imposed. Section 291 of the Internal Revenue Code (Appendix, *infra*) provides for the imposition of the penalty unless it is shown that the failure to file the return was due to reasonable cause and not

to willful neglect. The Tax Court took the view (R. 17) that the evidence did not suggest that the taxpayer was willfully negligent but further held, five judges dissenting, that the failure to file was not due to a reasonable cause within the meaning of the law. In affirming the decision of the Tax Court, the Circuit Court of Appeals said (R. 30–31) that the question is one of fact and peculiarly within the province of the Tax Court (*Commissioner* v. *Lane-Wells Co.*, 321 U. S. 219, 225; *Paymer* v. *Commissioner*, 150 F. 2d 334, 337 (C. C. A. 2d)), and an innocent mistake by a taxpayer which leads him to believe he is not required to file a return is of itself insufficient to show that his failure was due to reasonable cause within the meaning of the statute.

The taxpayer argues (Pet. 13–14) that it determined, following the decision in *Pittsburgh Brewing Co.* v. *Commissioner*, 107 F. 2d 155 (C. C. A. 3d), that its operations were at a loss, and therefore did not file an excess profits tax return. Taxpayer contends here, as it did below, that it was justified in relying on the *Pittsburgh* case. However, it has not been shown that the *Pittsburgh* case, even if correct, would have cut down the taxpayer's income to a point where no excess profits tax return would have been required. Moreover, the *Pittsburgh* case was wrongly decided and it was disapproved by both the Fourth Circuit and this Court in the *Virginian Hotel*

case, *supra*. The Fourth Circuit's decision in that case was rendered on January 2, 1943, and this Court's decision was rendered on June 7, 1943. In the circumstances, we submit that the taxpayer, when it determined its course of action for the taxable year ended February 28, 1943, was not justified in assuming that it could safely follow the *Pittsburgh* case.[1]

4. In conjunction with the petition for certiorari, the taxpayer has moved this Court (Pet. 15) to defer consideration of its application for the writ until such time as Congress shall have acted upon a bill, H. R. 1104, introduced by Representative Hobbs on January 20, 1947, and referred to the Committee on Ways and Means. Apparently this bill has not yet been reported out of committee. On pages 17–20 of taxpayer's petition for certiorari there is printed a copy of Mr. Stam's letter of March 17, 1947, to the Chairman of the Ways and Means Committee which points out the administrative difficulties which would arise if the bill were passed in its present form.

We oppose this motion, and urge that consideration of the taxpayer's application for certiorari should not be delayed pending the final outcome of the bill. The bill undertakes to overcome the effect of the *Virginian Hotel* case and to change the

[1] *Spies* v. *United States*, 317 U. S. 492, upon which taxpayer also relies (Pet. 13), is not at variance with our contentions here. It was a criminal case and it dealt with statutory provisions not here involved.

law only where depreciation has been allowed in excess of that properly allowable and resulted in no tax benefit. It will be noted that the bill does not undertake to change the law as to adjustments in respect to allowable depreciation. Under the decision in the instant case, all of the depreciation here involved was not only allowed but properly allowable, and in this view there is no adequate basis for the application of the bill's provisions. Moreover, no foundation appears for the taxpayer's allegation (Pet. 15) that the passage of the bill would relieve it of all the tax in controversy.

CONCLUSION

The decision is correct; there is no conflict; and the petition should be denied. The application for a postponement of action on the petition for certiorari should also be denied.

Respectfully submitted.

GEORGE T. WASHINGTON,
Acting Solicitor General.
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Special Assistants to the Attorney General.

MAY 1947.

APPENDIX

Internal Revenue Code:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) *Expenses.*—

(1) *Trade or Business Expenses.*—

(A) *In General.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

* * * * *

(i) *Basis for Determining Loss.*—The basis for determining the amount of deduction for losses sustained, to be allowed under subsection (e) or (f), and for bad debts, to be allowed under subsection (k), shall be the adjusted basis provided in section 113 (b) for determining the loss from the sale or other disposition of property.

* * * * *

(l) *Depreciation.*—A reasonable allowance for the exhaustion, wear and tear (in-

cluding a reasonable allowance for obsolescence)—

(1) of property used in the trade or business, or

(2) of property held for the production of income. * * *

* * * * *

(n) *Basis for Depreciation and Depletion.*—The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be as provided in section 114.

* * * * *

(26 U. S. C., Supp. V, 23.)

SEC. 24. ITEMS NOT DEDUCTIBLE.

(a) *General Rule.*—In computing net income no deduction shall in any case be allowed in respect of—

* * * * *

(2) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate;

(3) Any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made;

* * * * *

(26 U. S. C. 24.)

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (Unadjusted) of Property.*—The basis of property shall be the cost of such property; except that—

* * * * *

(b) *Adjusted Basis.*—The adjusted basis for determining the gain or loss from the sale or other disposition of property, when-

ever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided.

(1) *General Rule.*—Proper adjustment in respect of the property shall in all cases be made—

* * * * *

(B) in respect of any period since February 28, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent allowed (but not less than the amount allowable) under this chapter or prior income tax laws.

* * * * *

(26 U. S. C. 113.)

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

(a) *Basis for Depreciation.*—The basis upon which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in section 113 (b) for the purpose of determining the gain upon the sale or other disposition of such property.

* * * * *

(26 U. S. C. 114.)

SEC. 291. FAILURE TO FILE RETURN.

In case of any failure to make and file return required by this chapter, within the time prescribed by law or prescribed by the Commissioner in pursuance of law, unless it is shown that such failure is due to reasonable cause and not due to willful neglect, there shall be added to the tax: 5 per centum if the failure is for not more than thirty days with an additional 5 per centum for each additional thirty days or fraction thereof during which such failure continues, not exceeding 25 per centum in the

aggregate. The amount so added to any tax shall be collected at the same time and in the same manner and as a part of the tax unless the tax has been paid before the discovery of the neglect, in which case the amount so added shall be collected in the same manner as the tax. The amount added to the tax under this section shall be in lieu of the 25 per centum addition to the tax provided in section 3612 (d) (1). (26 U. S. C. 291.)

SEC. 718 [as added by Section 201 of the Second Revenue Act of 1940, c. 757, 54 Stat. 974, and as amended by Section 218 of the Revenue Act of 1942, c. 619, 56 Stat. 798].

EQUITY INVESTED CAPITAL.

(a) *Definition.*—The equity invested capital for any day of any taxable year shall be determined as of the beginning of such day and shall be the sum of the following amounts, reduced as provided in subsection (b)—

(1) *Money Paid In.*—Money previously paid in for stock, or as paid-in surplus, or as a contribution to capital;

(2) *Property Paid In.*—Property (other than money) previously paid in (regardless of the time paid in) for stock, or as paid-in surplus, or as a contribution to capital. Such property shall be included in an amount equal to its basis (unadjusted) for determining loss upon sale or exchange. If the property was disposed of before such taxable year, such basis shall be determined under the law applicable to the year of disposition, but without regard to the value of the property as of March 1, 1913. If the property was disposed of before March 1, 1913, its basis shall be considered to be its

fair market value at the time paid in. If the unadjusted basis of the property is a substituted basis, such basis shall be adjusted, with respect to the period before the property was paid in, by an amount equal to the adjustments proper under section 115 (l) for determining earnings and profits;

(3) *Distributions in Stock.*—Distributions in stock—

(A) Made prior to such taxable year to the extent to which they are considered distributions of earnings and profits; and

(B) Previously made during such taxable year to the extent to which they are considered distributions of earnings and profits other than earnings and profits of such taxable year;

(4) *Earnings and Profits at Beginning of Year.*—The accumulated earnings and profits as of the beginning of such taxable year; * * *

* * * * * *

(26 U. S. C., Supp. V, 718.)

SEC. 729 [as added by Section 201 of the Second Revenue Act of 1940, c. 757, 54 Stat. 974, and as amended by Section 205 of the Revenue Act of 1942, c. 619, 56 Stat. 798].

LAWS APPLICABLE.

(a) *General Rule.*—All provisions of law (including penalties) applicable in respect of the taxes imposed by Chapter 1, shall, insofar as not inconsistent with this subchapter, be applicable in respect of the tax imposed by this subchapter.

(b) *Returns*—

* * * * * *

(2) *No Return Required.*—Notwithstanding subsection (a), no return under section

> 52 (a) shall be required to be filed by any taxpayer under this subchapter for any taxable year for which its excess profits net income, computed with the adjustments provided in section 711 (a) (2) and placed on an annual basis as provided in section 711 (a) (3), is not greater than $5,000 or, in the case of a mutual insurance company (other than life or marine) which is an interinsurer or reciprocal underwriter, is not greater than $50,000.
>
> * * * * *
>
> (26 U. S. C., Supp. V, 729.)

Treasury Regulations 111, promulgated under the Internal Revenue Code:[2]

> SEC. 29.23 (a)–4. *Repairs.*—The cost of incidental repairs which neither materially add to the value of the property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition, may be deducted as expense, provided the plant or property account is not increased by the amount of such expenditures. Repairs in the nature of replacements, to the extent that they arrest deterioration and appreciably prolong the life of the property, should be charged against the depreciation reserve if such account is kept. (See sections 29.23 (l)–1 to 29.23 (l)–10, inclusive.)

[2] Treasury Regulations 111 are applicable only to years beginning after December 31, 1941. Treasury Regulations 103, also promulgated under the Internal Revenue Code, are applicable to earlier years beginning after December 31, 1938. Sections 19.23 (a)–4, 19.23 (l)–1, 19.23 (l)–2, 19.23 (l)–4, 19.23 (l)–5, 19.113 (a)–1, 19.113 (a)–2 and 19.113 (b) (l)–1 of Treasury Regulations 103 do not differ from the corresponding provisions of Treasury Regulations 111, above quoted, in any material respect.

SEC. 29.23 (l)–1. *Depreciation.*—A reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in the trade or business, or treated under section 29.23 (a)–15 as held by the taxpayer for the production of income, may be deducted from gross income. For convenience such an allowance will usually be referred to as depreciation, excluding from the term any idea of a mere reduction in market value not resulting from exhaustion, wear and tear, or obsolescence. The proper allowance for such depreciation is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate), whereby the aggregate of the amounts so set aside, plus the salvage value, will, at the end of the useful life of the depreciable property, equal the cost or other basis of the property determined in accordance with section 113. Due regard must also be given to expenditures for current upkeep. * * *

SEC. 29.23 (l)–2. *Depreciable Property.*—The necessity for a depreciation allowance arises from the fact that certain property used in the business, or treated under section 29.23 (a)–15 as held by the taxpayer for the production of income, gradually approaches a point where its usefulness is exhausted. The allowance should be confined to property of this nature. In the case of tangible property, it applies to that which is subject to wear and tear, to decay or decline from natural causes, to exhaustion, and to obsolescence due to the normal progress of the art, as where machinery or other property must be replaced by a new invention, or due to the inadequacy of the property to the

growing needs of the business. It does not apply to inventories or to stock in trade, or to land apart from the improvements or physical development added to it. It does not apply to bodies of minerals which through the process of removal suffer depletion, other provisions for this being made in the Internal Revenue Code. (See sections 23 (m) and 114.) Property kept in repair may, nevertheless, be the subject of a depreciation allowance. (See section 29.23 (a)–4.) The deduction of an allowance for depreciation is limited to property used in the taxpayer's trade or business, or treated under section 29.23 (a)–15 as held by the taxpayer for the production of income. No such allowance may be made in respect of automobiles or other vehicles used solely for pleasure, a building used by the taxpayer solely as his residence, or in respect of furniture or furnishings therein, personal effects, or clothing; but properties and costumes used exclusively in a business, such as a theatrical business, may be the subject of a depreciation allowance.

SEC. 29.23 (l)–4. CAPITAL SUM RECOVERABLE THROUGH DEPRECIATION ALLOWANCES.—The capital sum to be replaced by depreciation allowances is the cost or other basis of the property in respect of which the allowance is made. (See sections 113 (a) and 114.) To this amount should be added from time to time the cost of improvements, additions, and betterments, and from it should be deducted from time to time the amount of any definite loss or damage sustained by the property through casualty, as distinguished from the gradual exhaustion of its utility which is the basis

of the depreciation allowance. (See section 113 (b).) * * *

SEC. 29.23 (l)–5. METHOD OF COMPUTING DEPRECIATION ALLOWANCE.—The capital sum to be recovered shall be charged off over the useful life of the property, either in equal annual installments or in accordance with any other recognized trade practice, such as an apportionment of the capital sum over units of production. Whatever plan or method of apportionment is adopted must be reasonable and must have due regard to operating conditions during the taxable period. The reasonableness of any claim for depreciation shall be determined upon the conditions known to exist at the end of the period for which the return is made. If the cost or other basis of the property has been recovered through depreciation or other allowances no further deduction for depreciation shall be allowed. The deduction for depreciation in respect of any depreciable property for any taxable year shall be limited to such ratable amount as may reasonably be considered necessary to recover during the remaining useful life of the property the unrecovered cost or other basis. The burden of proof will rest upon the taxpayer to sustain the deduction claimed. Therefore, taxpayers must furnish full and complete information with respect to the cost or other basis of the assets in respect of which depreciation is claimed, their age, condition, and remaining useful life, the portion of their cost or other basis which has been recovered through depreciation allowances for prior taxable years, and such other information as the Commissioner may require in substantiation of the deduction claimed. * * *

SEC. 29.113 (a)-1. SCOPE OF BASIS FOR DETERMINING GAIN OR LOSS.—The basis of property for the purpose of determining gain or loss from the sale or other disposition thereof is the unadjusted basis prescribed in section 113 (a), adjusted for the various applicable items specified in section 113 (b). Unless otherwise indicated, the word "basis," as used in this section and sections 29.113 (a)-2 to 29.113 (a) (22)-1, inclusive, has reference to the unadjusted basis. * * *

SEC. 29.113 (a)-2. GENERAL RULE.—In general, the basis of property is the cost thereof. This rule is subject, however, to the exceptions stated in sections 113 (a) (1) to 113 (a) (21), inclusive.

SEC. 29.113 (b) (1)-1. ADJUSTED BASIS: GENERAL RULE.—The adjusted basis for determining the gain or loss from the sale or other disposition of property is the cost of such property or, in the case of such property as is described in section 113 (a) (1) to (21), inclusive, the basis therein provided, adjusted to the extent provided in section 113 (b).

The cost or other basis shall be properly adjusted for any expenditure, receipt, loss, or other item, properly chargeable to capital account, including the cost of improvements and betterments made to the property. * * *

The cost or other basis must also be decreased by the amount of the deductions for exhaustion, wear and tear, obsolescence, amortization, and depletion to the extent such deductions have in respect to any period since February 28, 1913, been allowed (but such decrease shall not be less than the amount of deductions allowable) under

chapter 1 or prior income tax laws. The adjustment required for any taxable year or period is the amount allowed or the amount allowable for such year or period under the law applicable thereto, whichever is the greater amount. A taxpayer is not permitted to take advantage in a later year of his prior failure to take any depreciation allowance or of his action in taking an allowance plainly inadequate under the known facts in prior years. The determination of the amount properly allowable shall, however, be made on the basis of facts reasonably known to exist at the end of such year or period. The aggregate sum of the greater of such annual amounts is the amount by which the cost or other basis of the property shall be adjusted. * * *

Treasury Regulations 112, promulgated under the Internal Revenue Code:

SEC. 35.729–1. TIME AND PLACE FOR FILING RETURNS AND INFORMATION TO BE INCLUDED.—Excess profits tax returns shall be filed at the same time and place as the time and place prescribed in sections 53 and 235 and the income tax regulations under such sections for the filing of income tax returns. The excess profits tax return of a corporation of income received or accrued

(a) from the date of its incorporation to the end of its first accounting period, where the period between the date of incorporation and the end of such period is less than 12 months, or

(b) from the beginning of its last accounting period to the date it ceases operations and is dissolved, retaining no assets, where the period between the beginning of the accounting period and such date is less

than 12 months, shall be considered as a return for a fractional part of a year consisting of such period, and shall be filed within the time prescribed for filing returns for taxable years of less than 12 months.

The excess profits tax return shall be on Form 1121 (revised), and such return shall contain all the information required by such form and by these regulations with respect to computation of such tax. The return, however, requires the computation of the tax with only the credit which results in the lesser tax, and a return so filed meets the requirements of the statute. Thus a taxpayer may omit from the return the computation and information with respect to the excess profits credit under section 713 or section 714 which does not result in the lesser excess profits tax and may omit the computation and information with respect to the excess profits net income otherwise to be computed with such omitted credit. A return filed in this manner shall be audited as filed, regardless of whether it may be determined that the use of the omitted credit would result in a lesser tax. A corporation which files a return is not, by reason of the fact that only one method of computing its credit is employed, precluded from using the other method in the computation of its excess profits tax for such taxable year and, if an overpayment results, from filing a claim for the refund of such overpayment within the applicable period of limitation.

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